Accounting and Auditing Policy Committee
Attn: Wendy Comes
441 G. Street, NW, Suite 3B18
Washington, DC 20548

Dear Ms. Comes:

The attached issue paper “Disclosure Requirements for Credit Subsidy Expense”, is the product of the Credit Reform Subgroup created under the auspices of the Government-wide Audited Financial Statements Task Force. The paper outlines recommended changes in the accounting standards for direct loans and loan guarantees and interpretations of the standards on the display of the components of subsidy expense.

The Statement of Federal Financial Accounting Standards (SFFAS) No. 2, *Accounting for Direct Loans and Loan Guarantees,* requires that:

> “For the fiscal year during which new direct or guaranteed loans are being disbursed, the components of the subsidy expense of those new direct loans and loan guarantees are recognized separately among interest subsidy costs, default costs, fees and other collections, and other subsidy costs” (para. 25)

Based on this standard, OMB bulletin 97-01, *Form and Content of Agency Financial Statements* (pages 51-52 and 55-56), requires the breakout of subsidy expense of new direct loans and loan guarantees to be disclosed in the footnote on direct loans and loan guarantees.

The subgroup on Credit Reform has concluded for reasons explained in the enclosed paper that the requirement in its present form does not provide the kind of useful information that was intended.

We are submitting this paper to the Accounting and Auditing Policy Committee for review and recommendation to the Federal Accounting Standards Advisory Board (FASAB).

Sincerely,

Shirley I. Hanberry
Chairperson, Government-wide
Audited Financial Statements Task
Force on Credit Reform

Enclosures

cc: Gerald Murphy
William Patriarca

GOVERNMENTWIDE AUDITED
FINANCIAL STATEMENTS TASK FORCE
CREDIT REFORM

Disclosure Requirements for Credit Subsidy Expense
Issue Paper

Issue Statement

The overall goal of disclosing credit subsidy expense[1] components is to provide decision makers with meaningful details about the cost and performance of a credit program for the current year. The current disclosure standard established in SFFAS No. 2, Accounting For Direct Loans And Loan Guarantees, and the financial statement preparation requirements of OMB Bulletin 97-01 do not meet this goal. How should agencies disclose interest subsidy costs, default costs, fees and other collections, and other subsidy costs in their annual financial statements?

Discussion of the Issue

Paragraph 25 of SFFAS No. 2 states "For the fiscal year during which new direct or guaranteed loans are disbursed, the components of the subsidy expense of those new direct loans and loan guarantees are recognized separately among interest subsidy costs, default costs, fees and other collections, and other subsidy costs." Further, paragraph 87 states "the Board believes that by reporting the subsidy expense components of direct or guaranteed loans disbursed during the reporting year, the cost components of newly disbursed direct loans and loan guarantees can be compared with those of prior years. The cost component information would be valuable for making credit policy decisions, monitoring portfolio quality, and improving credit performance. Information on interest subsidies and fees would help in making decisions on setting interest rates and fee levels. Information on default costs would help in evaluating credit performance." Based on this standard, pages 51, 52, 55, and 56 of OMB Bulletin 97-01 require agencies to disclose these subsidy expense components in the footnote on direct loans and loan guarantees.

In most programs, the subsidy cost of loans and guarantees is obligated in the budget year, while disbursements occur over more than one year. As a result, more than one cohort[2] disburses during the financial statement reporting year for most programs. For

---

[1]The current standard and this issue paper use the terms cost and expense interchangeably.

[2]Cohorts are all direct loans or loan guarantees of a program for which a subsidy appropriation is provided for a given fiscal year, even if disbursements occur in subsequent years. For direct loans and loan guarantees for

example, during fiscal year 1996, an agency could record subsidy expense related to disbursements from the 1994, 1995, and 1996 cohorts. The current standard makes the subsidy expense component disclosure less comparable and meaningful than intended because agencies must aggregate subsidy costs for the current year cohort with subsidy costs from prior cohorts. In particular, changes in law and program administration often occur. As a result, loans disbursed from programs over multiple years have different characteristics. Therefore, amounts disclosed in the current year's financial statements do not represent the program characteristics or expenses of any given year of the program.

In addition, because many credit programs disburse direct or guaranteed loans over more than one year, the subsidy expense aggregates different interest rates. Agencies calculate a disbursement-weighted average discount rate for credit programs that disburse direct or guaranteed loans over more than one year. This rate is an average of estimated interest rates over all years in the disbursement period, weighted for the estimated volume of disbursements in each year. This estimated rate is used to discount the cohort's cash flows and calculate the subsidy rate. The subsidy expense for the direct loans or loan guarantees is recognized during the fiscal year the loans are disbursed based on this estimated discount rate. A reestimate is subsequently needed to adjust the interest subsidy[3] for the difference between the estimated rate and the actual interest rate. Therefore, the disclosure of the interest subsidy expense for a given program currently reflects interest rates for all cohorts disbursing during the reporting year. As a result, the disclosed interest subsidy is not indicative of the actual interest subsidy for the current year's program activity because of the inclusion of prior year cohort activity.

Finally, although not required by SFFAS No. 2, most agencies disclose credit related information at the line of business level which aggregates many distinct programs. For example, agencies often combine different housing programs in the single family or multifamily housing line of business. In this case, programs with positive and negative subsidies could be offsetting each other. Thus, the current subsidy expense component disclosure is not providing program specific information upon which program specific decisions can be made.

Recommended Revision to SFFAS No. 2

Based on the preceding discussion, paragraph No. 25 of SFFAS No. 2 should be amended by the following.

---

which a subsidy appropriation is provided for 1 fiscal year, the cohort will be defined by that fiscal year. For direct loans and loan guarantees for which multi-year or no-year appropriations are provided, however, the cohort may be defined by the year of appropriation or the year of obligation.

[3]Since all of the subsidy cost components are based on a present value calculation, changes in the interest rate would also affect the other subsidy cost components.

> The entity shall disclose, at the program level, the total subsidy cost and subsidy components, expressed in terms of subsidy rates, for the direct loans obligated and loan guarantees committed for the current year cohort. These components of subsidy cost shall consist of interest subsidy cost, default cost (net of recoveries), fees, and other subsidy costs. The total disclosed subsidy rate and its components shall exclude reestimates and modifications, which are reported separately. Each subsidy component rate shall be calculated as a percentage of the present value of all direct or guaranteed loans estimated to be disbursed by the current year cohort over all estimated disbursement years. The total subsidy rate disclosed for that cohort shall be the initial subsidy rate calculated for budget execution. Information shall be provided about recent trends and fluctuations in the subsidy rate and its components. The disclosure shall include a narrative explaining in conceptual terms how the total subsidy rate differs from the total subsidy expense recognized on the financial statements.

Basis For the Recommendation

As discussed previously, for most credit programs, the subsidy component disclosure required by the current standard does not reflect the program characteristics of the reporting year or any other specific period. Thus, FASAB's objectives are not satisfied and decision makers are not provided with meaningful information about the cost and performance of a credit program for the current year. However, the division of subsidy expense among interest, defaults, fees, and other costs is meaningful and should be used by decision makers to monitor portfolio quality, make credit policy decisions, and improve credit performance. Using percentages instead of dollar amounts would allow comparisons of relative importance for a specific cohort during the year, across programs for a specific year, or across years for a given program.

By disclosing the initial subsidy rate calculated for budget execution, agencies will help integrate financial statement and budgetary information. The initial subsidy rate calculated for budget execution was used to determine the amount of budgetary resources obligated when a program makes direct loan obligations or loan guarantee commitments. This rate is also used to determine the amount of subsidy outlays recorded in the budget, which should relate to the amount of subsidy expense recorded in the financial statements, when direct or guaranteed loans are disbursed.

The disclosure narrative is necessary to prevent readers from assuming that the disclosure of subsidy expense components equals the total subsidy expense incurred during the year. This narrative is not expected to include a reconciliation of the disclosed rate and the total subsidy expense recorded in the financial statements. The narrative should explain that the agency has disclosed the expected subsidy rates for the fiscal year and should provide meaningful information about recent trends and fluctuations in the subsidy rate.

The level of aggregation in the footnote disclosure should be consistent with the programs presented in the Statement of Net Costs. However, at management's discretion, an agency may want to disclose the subsidy rate components for smaller programs that were aggregated on the Statement of Net Costs. Finally, the disclosure of subsidy rate components should be at the credit program level, not the program account.[4]

The following is an example of the disclosure that would be prepared under the proposed revision to SFFAS No. 2.

Loan Program 1 Subsidy Rate Components	19X2	19X1
Defaults, net of recoveries	7%	5%
Interest	6%	5%
Fees	-4%	-4%
Other	6%	6%
Total Program 1 Subsidy Rate	15%	12%

During the fiscal year, the subsidy rate for loan program 1 increased 3 percentage points from the previous year. Generally, this increase was attributed to expected declines in the recoveries of foreclosed properties. As a result, the expected cost of defaults has increased. In addition, fluctuations in interest rates also contributed to the increased subsidy rate. The above rates do not represent a division of the total subsidy expense on the Statement of Net Cost primarily because loan program 1 disburses loans in more than one fiscal year after they were obligated. The subsidy rates presented in the above table are the amounts calculated for the respective year's budget execution. As a result, these rates (1) exclude reestimates and modifications, (2) include the subsidy cost of loans obligated during the current year that will be disbursed in subsequent years, and (3) do not include the subsidy cost of loans disbursed during the year that were obligated in prior fiscal years.

[4] OMB Circular A-11 defines the program account as "the budget account into which an appropriation to cover the subsidy cost of a direct loan or loan guarantee program is made and from which such cost is disbursed to the financing account."